Nos. 12,728-12,729

In the United States Court of Appeals for the Ninth Circuit

ROLLINGWOOD CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

and

DAVID D. BOHANNON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

THERON LAMAR CAUDLE,
Assistant Attorney General.

ELLIS N. SLACK,
A. F. PRESCOTT,
CARLTON FOX,
Special Assistants to the Attorney General.

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OPINION BELOW

The only previous opinion is the Tax Court's memorandum findings of fact and opinion entered July 17, 1950 (R. 70-78), which is not reported.

JURISDICTION

The petition for review of the taxpayer, Rollingwood Corporation (R. 91-94), involves deficiencies in federal income and excess profits taxes determined by the Commissioner against it for the fiscal years ended May 31, 1944, 1945, 1946 and 1947, in the aggregate sums of $41,960.54 and $8,486.28, respectively. On May 25, 1948, the Commissioner mailed the taxpayer a notice of deficiencies in such taxes in these amounts. (R. 10-12.) Within ninety days thereafter and on August 19, 1948, the taxpayer filed a petition with the Tax Court for a redetermination of such deficiencies under Section 272 (a) (1) of the Internal Revenue Code. (R. 3, 5-12.) The decision of the Tax Court that there are deficiencies in such taxes in the aggregate amounts aforesaid was entered July 17, 1950. (R. 79.) The proceeding is brought to this Court by petition for review filed October 9, 1950 (R. 91-94), under the provisions of Section 1141 (a) of the Code, as amended by Section 36 of the Act of June 25, 1948.

The petition for review of David D. Bohannon (R. 118-123) involves the deficiencies in the federal income and excess profits taxes of the taxpayer, Rollingwood Corporation, for the fiscal years and in the amounts aforesaid, of which he admits liability as transferee of the assets of that corporation for the tax deficiencies, if any, finally found to be due and owing from it by reason of the matters brought before the Tax Court by it in the proceeding above mentioned. On May 25, 1948, the Commissioner mailed to Bohannon a notice that he had determined deficiencies in such taxes for those years in the amounts stated and that the aggregate amount of such deficiencies, with interest as provided by law, constituted his liability as such transferee. (R. 109-110.) Within ninety days thereafter, and on August 19, 1948, Bohannon, as such transferee, filed a

petition with the Tax Court for a redetermination of such deficiencies under Section 272 (a) (1) of the Code, in which he likewise admitted his transferee liability if the corporation was finally held liable for such deficiencies. (R. 102, 104-108.) The decision of the Tax Court that the aggregate amount of such deficiencies was due from Bohannon as such transferee was entered July 17, 1950. (R. 115.) The proceeding is brought to this Court by petition for review filed October 9, 1950 (R. 118-123), also under the provisions of Section 1141 (a) of the Code, as amended by Section 36 of the Act of June 25, 1948.

Upon stipulation of the parties (R. 126-127), the motion of the taxpayer and its transferee, Bohannon, to consolidate the two proceedings for the purpose of review by this Court (R. 127-128) was granted by the Court (R. 129).

QUESTION PRESENTED

Whether there is evidence to sustain the Tax Court's finding that the 700 houses in question were held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business, within the meaning of Section 117 (j) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra*.

STATEMENT

As has already been stated, the two proceedings on review here were consolidated for trial and report by stipulation of the parties (R. 15-16) and were tried by the Tax Court upon a joint stipulation of facts (R. 18-43). Reference throughout this brief to the "taxpayer" is to the Rollingwood Corporation. As has also been stated, the transferee, David D. Bohannon, has throughout admitted his liability as such in the event

the deficiencies against the corporation are sustained. The Tax Court's findings are based wholly on the stipulation of facts (R. 71-75), and may be summarized as follows:

On October 3, 1942, Bohannon filed an F.H.A. application for priorities of building material for the construction of 400 houses for disposal to defense workers on what was known as the lease-option plan, pursuant to which each house was to be rented to a certified defense worker at $50 per month with a thirty months' option to purchase the home for $4,800. (R. 72.) On January 9, 1943, Bohannon and one Ross M. Chamberlain organized the taxpayer corporation with a capital stock of 50 shares of the par value of $100 per share. Bohannon received 26 of these shares and Chamberlain 24. (R. 72-73.) On January 14, 1943, Bohannon filed a similar application for the construction of 300 additional houses on the same plan. (R. 73.) Bohannon assigned the two applications to the taxpayer, which employed the construction firm of Bohannon and Chamberlain, of which Bohannon and Chamberlain were the only general partners, to construct the houses. The acquisition of the acreage upon which the houses were built and their construction were financed by bank loans made by the taxpayer which were partially guaranteed by the Federal Housing Administration as well as by Bohannon and Chamberlain personally, and partly by Bohannon and Chamberlain alone. (R. 73-74.) Upon the completion of the houses on August 14, 1943, all of them were rented to certified defense workers under lease-option agreements pursuant to the stated plan. (R. 74.) During the taxpayer's fiscal years ended May 31, 1944, to 1947, inclusive, the taxpayer sold all of the houses at a gross profit of $587,234.36 as follows (R. 75):

Fiscal Year Ending	No. of Houses Sold (1)	(2)	(3)	(4)	Gross Profit on Sales
May 31, 1944.....	32	4	28	0	$15,946.04
May 31, 1945.....	224	46	175	3	144,191.74
May 31, 1946.....	357	221	136	0	183,421.46
May 31, 1947.....	188	15	165	8	243,675.12
Totals.....	801	286	504	11	$587,234.36

(1) The total number of houses sold exceeds 700, the number constructed, because the petitioner reacquired 81 houses by repossession and 24 by repurchase. On May 31, 1947, it owned 4 of the houses.
(2) Number of houses sold under option.
(3) Number of houses sold to non-tenants.
(4) Number of houses sold to tenants who rerented without option to buy.

The Tax Court concluded that the houses were held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. (R. 75.)

SUMMARY OF ARGUMENT

The Tax Court found that the houses in question were held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business within the meaning of the capital gains provisions of the Internal Revenue Code. Such finding is sustained by the stipulated facts, taken together with the failures of proof and the inferences to be drawn therefrom. This is so regardless of whether, in the context of these provisions, the word "primarily" was used by Congress in the sense of "chief," or "principal," as the taxpayer contends, or in the sense of "fundamental" or "essential," as the Commissioner contends. However the use of the word in the sense of "fundamental" or "essential" is not only implicit in the decisions of this Court, but accords with the definition given it by the Supreme Court in the framework of a similar statute. It is besides consonant with the legislative purpose in enacting the capital gains provisions of the federal taxing statutes, as disclosed by their legislative history. Certain circumstances, upon which the taxpayer relies to sustain a conclusion contrary to that reached by the Tax Court, are merely a part of the

overall picture of the taxpayer's operations, which it ignores. The taxpayer's contention that it was not engaged in the business of selling at all, because its selling activities were not accompanied by any extended development and sales activities, proceeds upon the erroneous assumption that the houses were constructed solely for rental purposes. The contrary is the fact, and the extent of the taxpayer's sales activities speaks for itself. The Tax Court's decision in the *Elgin Building Corp.* case, which the taxpayer contends is controlling here, was regarded by the Tax Court itself as distinguishable on its facts. In any event, it is obviously not controlling here.

ARGUMENT

There Is Ample Evidence to Sustain the Tax Court's Finding That the 700 Houses in Question Were Held by the Taxpayer Primarily for Sale to Customers in the Ordinary Course of Its Trade or Business in the Taxable Years Here in Question, Within the Meaning of Section 117 (j) of the Internal Revenue Code

A. *To sustain the Tax Court's decision on the facts of this case, it is immaterial how the word "primarily" is defined in the context of Section 117*

The taxpayer's contention that it did not hold the houses here in question primarily for sale to customers in the ordinary course of its business is predicated on the assumption that the word "primarily" was used by Congress in the context of the capital gains provisions of the Internal Revenue Code, and in the cognate provisions in the prior revenue laws, as meaning "first," or "chief," or "principal." On this assumption, the taxpayer asks this Court to draw a conclusion from the stipulated facts, contrary to that drawn therefrom by the Tax Court, that it held the property "primarily" for rent and not "primarily" for sale, within

the meaning of Section 117 (j) (1) of the Internal Revenue Code, Appendix, *infra*.

On the other hand, the Commissioner contends that the word "primarily" as used in the capital gains provision of the federal taxing statutes, connotes "fundamental" or "essential" and that, whether the taxpayer's sales activities were such, depends entirely upon their nature and extent; that is, upon whether they were substantial, regardless of the nature and extent of the taxpayer's rental activities.

But, while we shall undertake to demonstrate that this is the definition of "primarily" which is implicit in the decisions of this Court involving the application of the exception here in question, as also the definition given the word by the Supreme Court in a similar statute, and further that such definition implements the purpose of Congress in enacting it, as is disclosed by the legislative history of the capital gains provisions of the federal revenue laws, still, on the facts here, the decision of the Tax Court is not only correct, but, as we believe, the only possible one, even under the taxpayer's interpretation of the statute.

B. *Under the decisions of this Court, the question whether property is primarily held by the taxpayer for sale in the ordinary course of a business is regarded as depending solely on the nature and extent of his sales activities*

This Court has consistently held that whether property is held by the taxpayer primarily for sale within the meaning of the capital gains provisions of the revenue laws is essentially one of fact. (*Richards* v. *Commissioner,* 81 F. 2d 369, 370; *Field* v. *Commissioner,* 180 F. 2d 170; *Rubino* v. *Commissioner,* decided January 2, 1951 (1951 C.C.H., par. 9124)), and that the answer thereto revolves largely around the frequency

and continuity of the transactions claimed to result in a trade or business. (*Richards* v. *Commissioner, supra,* p. 273; *Commissioner* v. *Boeing,* 106 F. 2d 305, 309, certiorari denied, 308 U. S. 619; *Ehrman* v. *Commissioner,* 120 F. 2d 607, 610; *Field* v. *Commissioner, supra*). Thus, in the *Field* case, the Court affirmed the decision of the Tax Court upon the Tax Court's memorandum opinion of February 23, 1949 (1949 P-H T.C. Memorandum Decisions, par. 49,043), wherein the Tax Court had pointed out that, in both the *Richards* and *Ehrman* cases, this Court had rejected the taxpayers' reasons for purchasing the properties because of little significance, if the sales were so extensive as to establish them in the business of selling real estate on their own account. In this connection, it is to be observed that not only in the *Richards* and *Ehrman* cases, pp. 370 and 610, respectively, but also in the *Boeing* case, p. 309, as well, this Court also rejected the liquidation test in determining whether or not the taxpayer was carrying on a trade or business within the meaning of the capital gains provisions of the statute. But cf. *Delsing* v. *Commissioner* (C.A. 5th), decided January 5, 1951 (1951 C.C.H., par. 9125).

It is, of course, not necessary that such activity constitute the taxpayer's sole occupation or business, or that it occupy a majority of his time, and it may or may not be related to some other business activity of the taxpayer. *Harvey* v. *Commissioner,* 171 F. 2d 952 (C.A. 9th). See also *Snell* v. *Commissioner,* 97 F. 2d 891 (C.A. 5th).

Thus, while, in applying these provisions to the different situations which were presented in the various cases decided by it, this Court appears never actually to have defined the word "primarily" as therein used, nevertheless, its holdings in these cases are unquestionably predicated on the view that the nature and ex-

tent of the taxpayer's sales activities are in themselves determinative of whether the property was so held, and, by the same token, not upon a view ~~that~~ as to their relative importance *vis-a-vis* some other business activity in which he was also engaged.

Of course, in the case at bar, both the taxpayer's renting and selling activities involved the same houses, and they may therefore be regarded as a single business activity. If so, the fact that each was substantial would obviously justify a finding under the decisions of this Court, already referred to, that the houses were held primarily for both rent and sale. But the situation would be no different, we submit, if each of these activities is regarded as a separate one, or independent of the other. In such event, too, the principle of these cases is applicable that the test of whether or not the houses were held primarily in connection with either one of these activities likewise depends upon the nature and extent thereof.

C. *The Supreme Court has defined the word "principal" to mean "fundamental," "essential," and hence "substantial" in a similar situation where it regarded it necessary to do so in order to implement the purpose of the statute*

In the case of *Board of Governors* v. *Agnew,* 329 U. S. 441, the Supreme Court recognized the fact that Congress had used the word "primarily" in different statutes with different connotations, depending upon the purpose of the particular statute. Thus, in that case, the Court said that, while one of the meanings of the word "primarily" when applied to a single subject is "first," "chief," or "principal," in the context of the provisions of the statute there under consideration, it meant "essentially," "fundamentally," and thus "substantial."

The provisions there in question were those of Section 32 of the Banking Act of 1933, c. 89, 48 Stat. 162, as amended, which prohibited, *inter alia,* any member of a partnership "primarily engaged" in the underwriting business from serving at the same time as an officer, director, or employee of a member bank of the Federal Reserve System. The purpose of the provision was to prevent such officer, director or employee from inducing the bank to purchase securities which his firm was underwriting. The respondents in that case were directors of the Paterson National Bank which was a member of the Federal Reserve System and were also partners of the brokerage firm of Eastman, Dillon & Company, whose underwriting business constituted less than 50 percent of its other business. The Court of Appeals for the District of Columbia (153 F. 2d 785) had construed the word "primarily" to mean "first," "chief," or "principal" in the context of the statute, and accordingly had held that the firm was not "primarily engaged" in underwriting, because its underwriting activities did not by any quantitative test exceed 50 percent of its total business. The Supreme Court, however, said that it took a different view. It held that, in the context of Section 32, and in order to implement the stated legislative purpose thereof, the word "primarily" must be read as referring to a function or activity which was "essential" or "fundamental," and hence to one which was "substantial," so that, if the firm's underwriting business was substantial, it was engaged therein in a "primary" way, even though by any quantitative test underwriting may not have been its chief or principal activity.

We do not argue that the decision of the Supreme Court in this case is necessarily controlling of the meaning of the word "primarily" as used in the capital gains provisions of the federal taxing statutes. We

do say, however, that the Supreme Court made it clear therein that the meaning of the words in a given statute depends entirely upon the purpose which Congress intended to subserve in enacting it. Thus, as we shall undertake to show under our next subpoint (D), in the case of the capital gains provisions, their legislative history clearly discloses a continuing Congressional purpose sharply to distinguish taxwise between business gains and profits from the sale of property and those which are not such. And, in order adequately to implement that purpose, Congress must of necessity—as is indeed suggested, or at least inferable from, the decisions of this Court, above referred to—be deemed to have used the word "primarily" in the same sense that it used it in Section 32 of the Banking Act of 1933, namely, in the sense of "fundamentally" or "essentially."

D. *The legislative history of the capital gains provisions discloses a continuing Congressional purpose sharply to distinguish taxwise between property held for sale in the ordinary course of a trade or business and that which was not so held*

When Congress first evolved the idea in 1921 of taxing gain from the sale of "capital assets" at different rates from business gains and profits, it defined the term "capital assets" by Section 206 of the Revenue Act of 1921, c. 136, 42 Stat. 227, as including all property, with certain stated exceptions, namely (1) that held for the personal use or consumption of the taxpayer or his family; (2) stock in trade of the taxpayer; and (3) other property of a kind which would properly be included in inventory of the taxpayer if on hand at the close of the taxable year. The reason given for not taxing property not held for sale in the ordinary course of a business, such as stock in trade and that includible

in inventories, at ordinary rates was that the sale of capital assets, such as farms, mineral properties, and other similar property—that is, property that was used in connection with a business as distinguished from that held for sale therein—was then severely retarded by the fact that gains and profits earned over a series of years, as a result of holding such property, were under then existing provisions of law taxed as a lump sum, with the result that desirable sales thereof were delayed. See H. Rep. No. 350, 67th Cong., 1st Sess., p. 10 (1939-1 Cum. Bull. (Part 2) 168, 176); S. Rep. No. 275, 67th Cong., 1st Sess., pp. 12-13 (1939-1 Cum. Bull. (Part 2) 181, 89).

The first amendments of these provisions were made by Section 208 of the Revenue Act of 1924, c. 234, 43 Stat. 253. These were two in number, namely, (1) the exception relating to property held for personal use was dropped, with which we are not, however, concerned here, and, (2) there was added the exception of "property held by the taxpayer *primarily* for sale in the course of his trade or business." The italics are supplied for emphasis since it is here that the word "primarily" first appeared in these provisions. It is therefore of the utmost importance that the reasons therefor be understood. Both the House and Senate committee reports explained that the sole reason for the addition of this exception was a purpose "to remove any doubt as to whether property which is held primarily for resale constitutes a capital asset, whether or not it is the type of property which under good accounting practice would be included in the inventory." See H. Rep. No. 179, 68th Cong., 1st Sess., p. 19 (1939-1 Cum. Bull. (Part 2) 241, 255), and S. Rep. No. 398, 68th Cong., 1st Sess., p. 22 (1939-1 Cum. Bull. (Part 2) 266, 281). In other words, the sole reason for making this change was to insure that *all*

property held for sale in the course of a trade or business be excepted from the definition of "capital assets," so that the gain from the sale of all property so held did not escape the imposition of the normal tax.

The next change requiring explanation here occurred in 1934 when the words "held by the taxpayer primarily for sale in the course of his trade or business," used in the 1924 Act, were changed by Section 117 of the Revenue Act of 1934, c. 277, 48 Stat. 640, so as to read "held by the taxpayer primarily for sale *to customers* in the *ordinary* course of his trade or business." The italics are supplied to indicate the added words. The sole purpose of this change was to make it impossible longer to contend, as it had been, that a stock speculator trading on his own account was not subject to the provisions of Section 117. See S. Rep. No. 558, 73d Cong., 2d Sess., p. 12 (1939-1 Cum. Bull. (Part 2) 586, 595), and particularly H. (Conference) Rep. No. 1385, 73d Cong., 2d Sess., p. 22, Amendment No. 66 (1939-1 Cum. Bull. (Part 2) 627, 632).

The next important change in the provisions was made in Section 117 (a) (1) of the Revenue Act of 1938, c. 289, 52 Stat. 447, to which another exception was added, namely, "property, *used* in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l)." The italics are supplied in order to point up the fact that this section for the first time specifically distinguished between property *held* and property *used* in a trade or business; and it is important here to note that the exact language of this amendment was later used in Section 117 (j) (1), which was added to the Code by Section 151 of the Revenue Act of 1942, c. 619, 56 Stat. 798, and is here involved.

The exception added in Section 117 (a) (1) of the 1938 Act was made solely in order to permit those who

had suffered losses on a sale (or on a forced disposition) of property *used* in a trade or business, as distinguished from that *held* therein, to offset such losses against business gains. The reason given in justification of the amendment was that gains and losses from the sale or other disposition of property used by the taxpayer in his trade or business were in reality business gains and losses, no less than gains or losses from the sale of property held by him for sale in the ordinary course of his trade or business. See H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 17, 34 (1939-1 Cum. Bull. (Part 2) 728, 732-733, 752); and S. Rep. No. 1567, 75th Cong., 3d Sess., p. 7 (1939-1 Cum. Bull. (Part 2) 779, 783).

By 1942, however, Congress had become concerned with also relieving the taxpayer who had made gains on the sale of such property, i. e. property *used* in connection with the taxpayer's trade or business. It was this concern which caused Congress to enact Section 117 (j) and thereby to relieve the taxpayer from the burden of the ordinary tax on gains derived from the sale of such property, unless the property was includible in his inventory, or was held by him "primarily" for sale in the ordinary course of his trade or business. At the same time, however, Congress wished to preserve the taxpayer's right to deduct his losses on such sales as ordinary losses. The device which it adopted to accomplish both results was to require the offsetting of such gains and losses against each other and to provide for the taxation of the gains, if they exceeded losses, at capital gain rates and the deduction of the losses from ordinary income, if these exceeded the gains. See H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 53-54 (1942-2 Cum. Bull. 372, 415); and S. Rep. No. 1631, 77th Cong., 2d Sess., p. 50 (1942-2 Cum. Bull. 504, 545).

We therefore submit that, during the entire period of some thirty years in which the capital gains provisions have been in effect, the primary purpose of Congress in making the various exceptions, as well as the changes therein, was to insure that gain from the sale of property held for sale—and for nearly fifteen years also that used—in the course of the taxpayer's trade or business be taxed at ordinary rates, and that only such property as was not so held or so used (except as provided in Section 117 (j) with regard to the gain from the sale of property so used), be accorded the preferential capital gain and loss treatment. It follows that there is nothing inconsistent with the *use* of property for rent and at the same time holding it for sale. This is made clear by the terms of the statute itself; for it provides that certain property used by the taxpayer in a trade or business shall be treated as a capital asset, but only such property "which is not" held primarily for sale. Thus, we submit, it is clear that the word "primarily," as used in this statute, does not mean first in point of time; if the underlying purpose of the building of the houses was their sale, then they were held "primarily" for sale. Indeed, we go further and say that, even though the chief purpose was rental, if the sale of the houses was also a substantial purpose, they still were held "primarily" for sale.

E. *The facts as stipulated, the failures of proof, and the inferences to be drawn therefrom sustain the Tax Court's finding in any view that may be taken of the statute*

It seems to us that, to sustain the Tax Court's finding in any view which may be taken of the statute, it is necessary only to review the facts as stipulated, in the light of the taxpayer's obvious failure of proof in re-

spect of certain important matters, and the reasonable inferences which are to be drawn therefrom.

However, before turning to a discussion of the facts, we desire to point out that the procedural question which the taxpayer raises as to the scope of review of a finding of the Tax Court based on stipulated facts (Br. 16-24), serves only to confuse the issue. In every case, the question on review of a fact finding of the Tax Court under the statute is whether its findings are or are not "clearly erroneous," and this, of necessity, depends upon whether the evidence, with proper inferences to be drawn therefrom, sustains the findings. It can make no real difference, in arriving at a conclusion that it does or does not, whether the appellate court, in final analysis, tests the Tax Court's findings directly by the stipulated facts, or whether it puts them aside until it has made its own findings and then compares those of the Tax Court therewith.

In either case, the rule is applicable that there can be no reversal of the Tax Court's fact findings, unless they are found to be clearly erroneous. The rational basis of the rule is not merely that the trier of the fact sees and hears the witnesses and is therefore best able to evaluate the credibility of their testimony, but also that a trial is to be had before the constituted trier of the facts, and that no party is entitled to another trial, on appeal, simply because the appellate court might, if it had itself been the trier of the facts, have reached a different conclusion on the evidence. Moreover, as a practical matter, in every case where the findings of the Tax Court are assailed on review, it becomes necessary for the appellate court to examine the evidence in order to determine whether such findings are justified thereby. It can, therefore, make little difference, as we have said, how the appellate court approaches the problem;

for, no matter how the case was tried below, in every non-jury case, the sole question on review of fact findings is whether they are supported by the facts as they were presented to the trier of the facts, with reasonable inferences to be drawn therefrom. Moreover, on appeal, such inferences should be those which are to be drawn from the evidence most favorable to the appellee ~~appellant~~ or ~~petitioner~~. We turn then to a consideration of the facts.

Prior to Pearl Harbor, that is, prior to December 7, 1941, one David D. Bohannon had been engaged in California in the business of subdividing and selling real property on a substantial and extensive scale. He was also the sole stockholder of a corporation known as Suburban Builders, Inc., which was engaged in the business of general contractor in the construction of homes for sale during and after construction. (R. 39-40.) Prior to the incorporation of the taxpayer by Bohannon and one Ross H. Chamberlain, as hereinafter explained, they had organized two corporations to construct privately owned war housing projects, one on August 9, 1941, known as Pacific Homes, Inc., and the other on June 10, 1942, known as Western Homes, Inc. The former constructed in all 341 houses and the other 559. Moreover, subsequent to the incorporation of the taxpayer, they organized the Greenwood Corporation, which constructed and rented 1,329 houses of which it sold 629 in its fiscal year ended June 3, 1945, and 449 in its fiscal year ended June 30, 1946. (R. 40-42.)

In order to obtain the necessary building material to construct the 700 houses in question, Bohannon made an F.H.A. application to build 400 houses for disposition to defense workers on what was known as the "rent-option plan." The plan provided for the rental of each house to such workers at $50 per month, coupled

with a thirty months' option given to the tenant to purchase the home for $4,800. Later in the same year, Bohannon made another similar application in order to obtain material for the building of 300 additional houses to be disposed of under the same type of plan. Bohannon assigned these applications to the taxpayer corporation, which he and one Chamberlain, who was Bohannon's associate in the construction business, had formed. The ground upon which the houses were to be built was purchased by the taxpayer, which then employed the construction firm of Bohannon and Chamberlain, of which they were the only general partners, to build the houses. The taxpayer had a capital of only $5,000, divided into 100 shares, of which 26 were issued to Bohannon and 24 to Chamberlain. The building of the houses was financed by loans made by the taxpayer which were partly guaranteed by the Federal Housing Administration, as also by Bohannon and Chamberlain personally, and partly by Bohannon and Chamberlain alone. Schedule L of Exhibit 18,[1] which is the taxpayer's income and declared excess profits tax return for the fiscal year ended May 31, 1944, shows that, in that fiscal year, the F.H.A. loans payable (which presumably refers to all of the loans made by the taxpayer), amounted to $3,090,000.

Immediately upon the completion of the project in August, 1943, the taxpayer rented all of the houses to certified defense workers with the option to purchase and commenced to sell the houses to them under the option in its fiscal year ended May 31, 1944. It continued to sell the houses thereafter, some under the options and some not, until all but four of them had been sold by the end of its fiscal year ended May 31, 1947. In all, the taxpayer thus sold 801 houses. This

[1] All of the exhibits referred to herein are exhibits attached to the stipulation of facts.

happened because it had reacquired 105 of them during this period, either by repossession or repurchase. (R. 74-75.)

The sales were made at a total gross profit of $587,-234.36. (R. 75.).[2] Exhibit 16 shows that the net profits from the sales for each of the taxable years ended May 31, 1944, 1945, 1946, and 1947 were in the amounts of $13,962.82, $68,899.22, $153,604.64, and $306,857.31, respectively. Schedule C of Exhibit 18 shows that the expenses of sale of 32 houses sold in the fiscal year ended May 31, 1944, were $344.17. Schedule C of Exhibit 22 shows that the expenses of sale of the 225 houses sold in the fiscal year ended May 31, 1945, were $52,293.02; Schedule C of Exhibit 24, that the miscellaneous expenses incidental to the sale of the 357 houses sold in the fiscal year ended May 31, 1946, were $320,-085.81, and that the commissions paid on those sales aggregated $5,075; and Schedule C of Exhibit 26, that the commissions paid in connection with the sale of the 188 houses made in the fiscal year ended May 31, 1947, amounted to $57,755.48 and the miscellaneous expenses incidental thereto to an additional sum of $35,020.39.

By way of contrast with the profits on the sales of the houses, Exhibit 16 shows the income, or loss, from the rental operations for the same fiscal years, but before allocation of administrative expenses thereto, to have been as follows: Income of $22,598.51 for the fiscal year ended May 31, 1944; income of $45,085.26 for the fiscal year ended May 31, 1945; a loss of $47,-605.91 for the fiscal year ended May 31, 1946, and a loss of $50,422.30 for the fiscal year ended May 31, 1947.

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[2] This amount does not include the sum of $65,456.15, profit taken up in the fiscal year ended May 31, 1947, on installment sales of prior years. Nor does it appear to include the amount of installment sales collected by Bohannon after the corporation was dissolved on May 31, 1947, and its assets distributed to him. (See Schedule C, Ex. 26.)

That is to say, the taxpayer's rental operations showed an over-all loss of $30,344.44 during the period of its existence.

Moreover, most of the sales were installment sales. It seems fairly clear, therefore, as has already been indicated (fn. 2, *supra*), that only a portion of the profits was taken into income by the taxpayer in each of its taxable years; for the corporation was dissolved on May 31, 1947, and its assets, valued at $130,000, were distributed to Bohannon, then its sole stockholder. These assets undoubtedly included not only the four unsold houses, but also the unpaid portions of installment contracts.

Also, not only by way of contrast with the expenses of sales, but by way of comparison with the gain from the rental operations themselves, the cost of the latter was enormous and out of all proportion to any possible gain therefrom. Thus Schedule B of Exhibit 18 shows that the cost of the rental operations for the taxpayer's first fiscal year during which only 32 houses were sold, ended May 31, 1944, and in which the gross rental profits were only $22,585.97 (Ex. 18, p. 1), was $321,-167.57, which included $111,206.79 interest on the loans; $66,480.10 as a charge for depreciation; $31,801.80 for maintenance and repairs; $19,879.42 for salaries; $10,-824.59 for F.H.A. insurance; $8,938.61 for fire and war damage insurance; $6,076.77 for automobile expenses and travel allowances; $4,442.97 for advertising, and other minor expenses. While the rental expenses were progressively reduced from year to year as the houses were sold, their scale remained such as to show that they would have continued to remain out of all proportion to any profits which could conceivably have been made had no sales been made and the project been continued as a rental one. Thus, a sheet attached to Exhibit 22 shows that the cost of the rental operations was

$293,598.61 for the fiscal year ended May 31, 1945, as against gross receipts by way of rental income of $337,624.03; a sheet attached to Exhibit 24 shows that the cost of rental operations for the fiscal year ended May 31, 1946, was $198,160.56, as against gross receipts by way of rental income of $145,058.48; and a sheet attached to Exhibit 26 shows that the cost of rental operations for the fiscal year ended May 31, 1947, was $68,098.79, as against gross receipts by way of rental income of $12,368.62.

It should be remembered that Bohannon was the prime mover in the taxpayer's activities and had, as stated, for years been engaged in the business of building dwelling house projects and selling houses therein. The war made it impossible for him, and his associate, Chamberlain, to continue in that business unless they constructed F.H.A. housing projects, because they could not otherwise have obtained the necessary building material to do so. Thus, under the lease-option plan of Bohannon's F.H.A. applications, they were enabled to continue their building and sales operations, albeit under certain restrictions, which, however, obviously did not prove to be any obstacle thereto. On the contrary, these restrictions actually subserved their sales activities by providing ready purchasers for the houses. No doubt, both anticipated this. There is, of course, no evidence to dispute the obvious inference that they did. In any case, they used the taxpayer as a convenient vehicle for the sales end of their operations. Here, too, there is no evidence from either Bohannon or Chamberlain, or, for that matter, from anyone else, to contradict this likewise obvious inference. That neither of them, nor anyone else, was called to testify that their main purpose was not to sell the houses but to rent them, can be explained on no other theory than that their over-all objective was the making of profit on

the construction and sale of the houses, rather than on the rental thereof. It seems to us fatuous to contend that men who had for years been engaged in the building and sale of large housing projects, should organize a $5,000 corporation to borrow more than $3,000,000, largely on their own personal guarantee, to build houses "primarily" for rental purposes, using the word "primarily" in the taxpayer's sense of "chiefly." Obviously, the amount borrowed could not have been repaid out of the rents, or otherwise than by a sale of the houses. And, of course, if Congress intended to use the word "primarily" in the sense of "essential," as we think it did, it may be assumed the taxpayer would concede that the houses were held primarily for sale within the meaning of the statute. For the taxpayer's sales activities were not only substantial, in the sense that they were continuous and important, but they were massive in all but its first taxable year, and, what is more, they were all inclusive, so that ultimately they resulted in the very destruction of the taxpayer's rental business and in the dissolution of the taxpayer itself.

It is to be noted that 256 of the houses were sold by the taxpayer prior to June 1, 1945 (R. 75), that is, during the period of hostilities. This was more than one third of the 700 built. But, of those sold during that time, only 50 were sold to the original tenants under the lease-option agreements; 203 of them were sold to non-tenants, and 3 to new tenants who were not given options to purchase. Of course, the fact that the taxpayer was able to sell 206 of the houses to non-tenants, as well as to new tenants, meant that that number of the original tenants had vacated the houses during the period of hostilities. Moreover, during the entire period of the taxpayer's existence, only 286 of the houses were sold to the original tenants. We do not know how many of

these were repossessed, although we do know that 105 houses which had been sold were repossessed. In any event, the majority of the remaining houses, including those that had been repossessed, were sold to non-tenants; only 11 of them being sold to new tenants who, however, had not been given options to purchase. In other words, none but the original tenants appears ever to have been given a long term rental agreement, thus, leaving the taxpayer a freer hand to sell.

Of course, only the general course of these events could have been foreseen. But the obvious inference they suggest is that the taxpayer's basic purpose was not the renting of the houses, which it accommodated to the exigencies of a situation requiring their sale, but that it was the sale of the houses, which it accommodated to a situation requiring their rental. To put it another way, the picture is not of a rental project which was forced into liquidation by the course of events, but of a sales project in connection with which the renting of the houses constituted only a means to the end.

What we have already said suffices, we think, to answer the taxpayer's contention that the circumstances to which it particularly adverts require this Court to draw the conclusion, contrary to that drawn by the Tax Court, namely, that the houses were held by it chiefly for rent. These circumstances may be summarized as follows:

(1) the advertising of the houses for rent (Br. 24-25);

(2) the critical war situation which led the Government to invite the construction of defense housing with rental conditions imposed thereon (Br. 25-28); and

(3) the character of the taxpayer's activities, both with respect to the renting of the houses and their sale

(Br. 28-32). Suffice it here to say that the taxpayer's argument based on these circumstances ignores the essential facts and particularly the over-all picture of its operations of which they are a part.

The taxpayer's further contention (Br. 33-45) that it was not engaged in the business of selling at all, because its selling activities were not accompanied by any extended development or sales activities, is wholly without merit. Such as it is, the argument proceeds upon the obviously erroneous assumption that the construction of the houses was undertaken solely for rental purposes. The contrary is obviously the fact, and its sales activities speak for themselves.

As far as concerns the taxpayer's final contention (Br. 45-50), that the Tax Court's memorandum decision of February 15, 1949, in the case of *Elgin Building Corp.* v. *Commissioner* (1949 P-H T. C. Memorandum Decisions, par. 49,015), is on all fours with the case at bar and should be followed here, it should suffice to say that the Tax Court, in its opinion in the case at bar, pointed out that the cited case was the sole reliance of the taxpayer below, but was to be distinguished on its facts. In any event, however, the Tax Court's decision therein is not controlling here.

CONCLUSION

For the reasons stated, the Tax Court's decisions should be affirmed.

Respectfully submitted,

THERON LAMAR CAUDLE,
Assistant Attorney General.
ELLIS N. SLACK,
A. F. PRESCOTT,
CARLTON FOX,
Special Assistants to the Attorney General.

MARCH, 1951.

APPENDIX

Internal Revenue Code:

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

(j) [as added by Sec. 151 (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798, and amended by Sec. 127 of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Gains and Losses from Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of Property Used in the Trade or Business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l) held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k) (1) or (2) is applicable.

(2) *General Rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of

capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

* * * * *

(26 U.S.C. 1946 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.117-7 [as amended by T. D. 5394, 1944 Cum. Bull. 274, 276]. *Gains and Losses from Involuntary Conversions and from the Sale or Exchange of Certain Property Used in the Trade or Business.*—Section 117 (j) provides that the recognized gains and losses

(a) from the sale, exchange, or involuntary conversion of property used in the trade or business of the taxpayer at the time of the sale, exchange, or involuntary conversion, held for more than six months, which is

(1) of a character subject to the allowance for depreciation provided in section 23 (l), or
(2) real property,

provided that such property is not of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of

the taxable year, or is not held by the taxpayer primarily for sale to customers in the ordinary course of trade or business, and

* * * * *

shall be treated as gains and losses from the sale or exchange of capital assets held for more than six months if the aggregate of such gains exceeds the aggregate of such losses. If the aggregate of such gains does not exceed the aggregate of such losses, such gains and losses shall not be treated as gains and losses from the sale or exchange of capital assets.

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